

SPECIAL REPORT

COINSURANCE CLAUSES CAN BE DEVASTATING

(09-04-2014)

This Special Report was written by Kenneth R. Hale, J.D., CPCU, AAI, LIC of Marsh & McLennan Agency LLC. Mr. Ken Hale can be contacted at 734-525-2412 or khale@mma-mi.com. More Special Reports are available at www.mma-mi.com.

Most policyholders are surprised to learn that their property insurance policies contain coinsurance clauses.

A simple way to determine if your policy includes such a provision is by looking for a percentage, such as 80%, 90% or 100%, next to the limit for building, personal property or business interruption coverage on the property insurance policy declarations page. If a percentage is listed this means that you have made a promise to the insurance company that the limit of coverage that you selected is at least equal to that percentage of the actual replacement value of what you are insuring.

Although some policyholders think that 100% is better than 80%, the reverse is actually true. You have no leeway with 100% coinsurance and have essentially promised that the replacement value you selected is 100% accurate.

Regardless of the coinsurance percentage, one of the first things the insurance company will do after a property insurance loss is test your values to see if you lived up to your promise. If you did not select a sufficient limit, you are penalized in proportion to the deficiency.

Stated simply, the coinsurance formula is as follows:

$$\frac{\text{The Value You Did Insure}}{\text{The Value You Should Have Insured}} = \text{Percent Insurance to Value}$$

For example, assume a policyholder insures their building at a replacement value of \$1,000,000 under a policy with an 80% coinsurance provision.

After a \$500,000 loss, the insurance company audits the actual replacement value and determines that the insured value should have been \$2,000,000 rather than \$1,000,000. Applying the coinsurance provision reveals that the policyholder only insured 55% of the actual replacement value, as opposed to the required 80%.

$\frac{\text{Did Insure } \$1,000,000}{\text{Should have Insured } \$2,000,000 \times 80\% = \$1,800,000} = 55\%$

In this case, the insurance company will reduce that policyholder's loss settlement by the amount it was underinsured. If on the other hand, the percent of insurance to value was greater than or equal to 80%, the coinsurance penalty would not apply and the insurance company would pay the full value of the loss up to the policy limit.

The Problems With Coinsurance

The main problem with coinsurance is that the policyholder cannot know, with any degree of certainty, the exact values that need to be insured absent an accurate appraisal of the replacement cost values. More specifically, the policyholder would need to obtain an appraisal of the property, not from a market value standpoint - which includes land and reflects the salability of the property, but rather from a replacement cost or reconstruction cost standpoint without considering land and which reflects the current material and labor costs as well as a contractor's profit.

In the case of personal property, the appraisal would need to reflect the replacement cost of machinery and equipment, leasehold improvements, inventory, office contents, computers, and the selling price of finished goods both inside and outside the building. While it is possible to obtain an appraisal of personal property, these appraisals usually do not include leasehold improvements, the replacement cost of inventory, or the selling price of work-in-progress. In fact, most personal property appraisals only include machinery and equipment on a market value basis, not replacement cost.

Even if you did have a current appraisal reflecting precisely what the policy requires, it is still not likely to be accurate because your appraisal may reflect an appraisal basis that is different than what the insurance company uses.

For example, the appraisal might be based upon your cost to replace as opposed to the cost of a general contractor. The appraisal might be based upon a union general contractor rather than a non-union general contractor. The appraisal might be based upon a general contractor that is a fire repair contractor as opposed to a regular contractor. The appraisal might reflect normal reconstruction times rather than emergency reconstruction times such as after a widespread catastrophic loss. The appraisal may not include the delay in obtaining labor and materials due to market conditions, and this is not an appropriate basis of the normal replacement cost of the building.

Any discrepancy between your appraisal and that of the insurance company may result in a higher reconstruction cost which would in turn have a negative impact on the coinsurance provision.

The policy itself does not give any guidance. The standard policy language regarding coinsurance for building and personal property is as follows:

1. Coinsurance

If a Coinsurance percentage is shown in the Declarations, the following condition applies.

(a) We will not pay the full amount of any loss if the value of Covered Property at the time of loss times the Coinsurance percentage shown for it in the Declarations is greater than the Limit of Insurance for the property.

As respects business interruption, the burden is even worse because it requires that the policyholder provide an accurate forecast of future values. The coinsurance clause for business interruption is as follows:

We will not pay the full amount of any Business Income loss if the Limit of Insurance for Business Income is less than:

(b)The Coinsurance percentage shown for Business Income in the Declarations; times the sum of:

- (1) The Net Income (Net Profit or Loss before income taxes); and*
- (2) Operating expenses, including payroll expenses, that would have been earned or incurred (had no loss occurred) by your “operations” at the described premises for the 12 months following the inception, or last previous anniversary date, of this policy (whichever is later).*

Note that the language requires that the policyholder insure what will be earned in the future. The bottom line is that you cannot be assured that your values are accurate even if you have the best of intentions and current appraisals in hand.

Suggestions for Avoiding Coinsurance Clauses

1. Some policies, such as the typical Business Owners policy, do not have coinsurance clauses to begin with but do have other coverage limitations.
2. Get the insurance company to agree with you up front that what you are insuring is what you should insure. This is known as an agreed value endorsement. It waives the coinsurance penalty clause during the policy term. This usually means that you will be required to sign and submit an annual “statement of values” to the insurance company attesting that the values you have disclosed are accurate to the best of your knowledge and belief.
3. Be certain that you have a rational basis as to how you establish your values. The insurance company could claim fraud if there is a major disparity between your values and what the values should be. For example, if you use \$35 per square foot as the replacement cost of the building and the actual replacement cost was \$100 per square foot, the insurance company is likely to reject your statement of values form after the fact.

In conclusion, coinsurance clauses can be devastating to your business, and you need to avoid them to the greatest degree possible.

This document is not intended to be taken as advice regarding any individual situation and should not be relied upon as such. Marsh & McLennan Agency LLC shall have no obligation to update this publication and shall have no liability to you or any other party arising out of this publication or any matter contained herein. Any statements concerning actuarial, tax, accounting or legal matters are based solely on our experience as consultants and are not to be relied upon as actuarial, accounting, tax or legal advice, for which you should consult your own professional advisors. Any modeling analytics or projections are subject to inherent uncertainty and the analysis could be materially affective if any underlying assumptions, conditions, information or factors are inaccurate or incomplete or should change.